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March 25, 2009

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: File No. SR-CBOE-2009-007

Dear Ms. Norris:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above referenced proposal ("Proposal") of the Chicago Board Options Exchange ("CBOE").[1] Under the Proposal, the CBOE proposes to allow its members to hedge options transactions before they are presented for execution on the exchange, a practice known as "anticipatory hedging" that is uniformly prohibited on all of the options exchanges today.

The ISE does not believe there is any justification for allowing firms to engage in anticipatory hedging activities. We view this activity as a form of front-running that may disadvantage both the customer order being executed and the trading crowd that is competing for the order in the auction process. In addition, the Proposal seeks to provide such "tied hedge" transactions inappropriate relief from the trade-through protections contained in the Intermarket Linkage Plan by improperly treating all tied hedge transactions as complex orders that would also be qualified contingent trades under Regulation NMS. Finally, the mechanics of how tied hedge transactions would be executed on the CBOE needs to be explored further, as it is not apparent how such trades could be accomplished as proposed.

Harmful Effects of Anticipatory Hedging

The options exchanges have not permitted members to front-run orders by trading in the underlying security before an options order is represented on the exchange for good reason. First, it gives the member with knowledge of a pending transaction an advantage over others in the auction market process, which results in less competition and worse prices for customers. Second, transactions in the underlying security may move the price in the underlying security and consequently the

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[1] Exchange Act Release No. 59435, (February 23, 2009), 74 F.R. 9115 (March 2, 2007).

option, resulting in a worse price for the options customer. Limiting the Proposal to large transactions does not mitigate either of these issues, as larger undisclosed options orders will require larger, more material transactions in the underlying security, which are more likely to affect prices.

Moreover, the Proposal does not permit the trading crowd to execute the options order without taking the hedge. The CBOE states that the purpose of this requirement is to ensure that the hedging position represented to the crowd would be a good faith effort to provide in-crowd market participants with the same opportunity as the member or member organization introducing the tied hedge order to compete most effectively for the option order. While this might explain why the hedge should be offered to the crowd, it does not justify requiring the crowd to take the hedge.[2] In fact, this could support greater internalization and less vigorous competition for price improvement. CBOE recognizes that firms will not bring a trade to the crowd if the firm may end up holding a pre-hedged stock position. However, it is because of their inability to pre-hedge today that customers receive the best price possible. Not allowing the crowd to freely compete for the options order without the hedge may act to the detriment of the customer order because it further encumbers the auction process and may prevent the customer from receiving an execution at all:

- When the market moves between the time the order is hedged and the time the order is presented on the floor, the hedge might become expensive relative to existing market conditions. Therefore, requiring the crowd to take the hedge at the same price will prevent the crowd from giving the options customer the best price for its options transaction.

- Other market participants might not want the hedge at the proposed price because they have different hedging strategies, securities positions or cost structures. Again, requiring the crowd to take the hedge at the same price will prevent the crowd from giving the options customer the best price for its options transaction.

- While the rule states that the hedge has to be offered to the crowd at the same price as the firm, it does not require that the price be at or better than the NBBO at the time the hedge was executed. The rule does not prohibit a firm from taking securities from inventory, nor does it address how such securities would need to be priced.

- The CBOE notes that there is a possibility that a customer order would not be executable because of market conditions in any of the non-CBOE markets in the underlying. This is particularly troublesome because the customer is being denied an execution for the fact that the member firm tied the member's own hedge to the options order before presenting it to the crowd.

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[2] The CBOE notes that its Proposal is similar to a proposal by the Philadelphia Stock Exchange in 2003. Securities Exchange Act Release No. 48875 (December 4, 2003), 68 F.R. 70072 (December 16, 2003). While the ISE objected to that proposal as well, the PHLX proposal required that the hedge be offered to the crowd, but the crowd was not required to take the hedge. The CBOE proposal is significantly more objectionable for the fact that it does not give the trading crowd the ability to compete for the option without taking the hedge.

Inappropriate Classification of Tied Hedge Transactions

Tied Hedge transactions are not, by default, complex orders unless they meet the definition of a "complex trade" under the uniform linkage rules. Unless the initial order being facilitated qualifies as a complex trade, a tied hedge transaction should not get treated as such under the CBOE priority rules for complex orders or the linkage rules. Additionally, tied hedge transactions where the customer order is for a single options series do not qualify for the qualified contingent trade exception to Rule 611(a) of Regulation NMS for the stock component:

- Complex orders are orders with multiple options and/or stock legs for the same account, whereas a tied hedge transaction represents a customer options order and a stock order for the broker-dealer's account. Qualified contingent trades also need to be for the same account. Allowing orders for two unrelated parties to be packaged together and deemed "contingent" is not the intent of either definition.

- The definition of a stock-option order requires the stock leg to be on the opposite side of the options leg. However, the stock leg in the tied hedge transaction will be on the same side of the market as the options leg. This definition again demonstrates that the intent of the complex order definition is for both the options and stock leg to be for the same account.

Uncertain Execution Mechanics

We do not understand how orders actually would be executed on the floor of the CBOE under the various existing rules for crossing orders, complex order priority, the interaction with the electronic book, the intermarket options linkage and Regulation NMS. For Example, assume the CBOE options market is $2 by 2.09 at the time a member receives a customer order to purchase 500 calls. If the member wants to facilitate the order, it will be selling 500 calls. The hedge for selling 500 calls with a delta of 50 is buying 25,000 shares of the underlying stock.

- Currently: Pursuant to CBOE Rule 6.74(b), a cross would be announced and the crowd might respond with offers that improve the existing 2.09 offer. Presumably, the floor broker will then execute the order according to the procedures in Rule 6.74(b)(iii).[3] Assume for this example that the customer order receives an execution at 2.08 partially against the trading crowd and partially against the facilitation order. Participants that sold call contracts to the customer might immediately hedge their positions by purchasing the underlying security at the prevailing market rate.

[3] It is unclear whether this requires the member to execute the order at a price that improves upon the best price offered by the crowd, as the rule specifies that the floor broker "must, on behalf of the public customer whose order is subject to facilitation, either bid above the highest bid in the market or offer below the lowest offer in the market" before crossing some or all of the order "at such customer's bid or offer."

- Under the proposal: The facilitating member executes the hedge before it sends the customer order to buy 500 contracts to the floor of the CBOE. Assume that the market for the underlying stock is 10 by 10.01 and the member is able to buy 9,500 shares at 10.01. Then the offer in the underlying market moves to 10.03, and the member buys another 11,000 shares. Then the offer moves to 10.04, and the member buys the remaining 4,500 shares. The average price of the 25,000 share hedge will be 10.0242.

    - The tied hedge cross order is offered to the crowd[4] – purchase 500 call options at 2.09 and purchase 25,000 shares at 10.0242. Assume the underlying market has moved so that the best offer is now 10.01. With the potential of a less expensive hedge, the trading crowd might be willing to execute the customer order at 2.08 as provided in the example above, but because the customer order has been tied to the hedge the order will either (i) not be executable because the stock price is outside the NBBO for the underlying; or (ii) the options side will get a less favorable execution price to make up for the cost difference on the equity side.

- Assuming the trade does execute, it is unclear how the participants will execute the equity trade at 10.0242 pursuant to the restriction contained in Regulation NMS regarding sub-penny orders. Additionally, if the ISE is offering at 2.07, the transaction above should not be executed on the CBOE because it would trade through the better price on the ISE.

There are many variations upon this example that should be considered carefully by the Commission. In particular, we note that with respect to electronic execution of orders, the Commission requires exchanges to detail how the system behaves in detail. The execution of orders on a trading floor should be subject to an equally rigorous standard. Moreover, considering that the manual handling of orders on a trading floor introduces additional time delays, the Commission should explore the various execution outcomes under the Proposal when market prices move in the underlying security and/or the options market and whether these outcomes are consistent with best execution principles given that the reason the customer order is being delayed (or denied an execution altogether) is to provide a better opportunity for broker-dealers to lock-in profit for orders they wish to internalize.

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[4] The text of the proposed rule states that hedge has to be "offered, at the execution price received by the member or member organization introducing the option, to any in-crowd market participant *<u>who has established parity or priority for the related options</u>* . . ." (emphasis added). It is unclear whether this qualification limits who is permitted to participate in the auction for the order under the procedures contained in Rule 6.74. If the number of participants who can now participate in the auction for the customer's order decreases, the rule obviously would limit the potential for price improvement.

For all of the reasons discussed above, we request that the Commission initiate proceedings to disapprove the Proposal.

Sincerely,

Michael J. Simon
Secretary

cc: Erik Sirri
Elizabeth King